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U.S. Regulators Increase Focus on ESG as Investor Demand Grows: What Private Equity Firms Need to Know

20 July 2020

The increased focus on Environmental, Social and Governance ("ESG") investing by the U.S. Securities and Exchange Commission ("SEC") and the U.S. Department of Labor ("DOL") comes at a time of growing demand for ESG and impact-themed investments from global investors. This article discusses the recent DOL and SEC activities relating to ESG investing and presents key takeaways for the private equity industry.

ESG & Impact Investing — Evidence of Increasing Importance in Private Equity

ESG, responsible investing and impact investing have gained traction in the private equity industry. Currently, nearly half of global private equity managers have an ESG policy in place, another 30% plan to implement one in the near future, and the majority of private equity managers report on ESG metrics to their investors.[1] Moreover, over 800 private equity fund managers have signed on to ESG and impact investing frameworks such as the U.N. Principles for Responsible Investment ("PRI") and the International Finance Corporation ("IFC") Operating Principles for Impact Management.[2] This trend is expected to continue, with nearly two-thirds of institutional investors expecting ESG to become more integral to the industry in the next 36 months.[3]

The growing importance of ESG and sustainable investing in private equity is perhaps most notably highlighted by the fact that several of the world's largest and most-established private equity firms all launched dedicated impact-focused private equity fund product lines in recent years, where defined impact objectives are a cornerstone of the investment strategy. Like ESG, impact investing is expected to continue to grow, with the IFC estimating the market size for total assets of potential impact investors to be in excess of $2 trillion.[4]

As discussed in our recent blog post, ESG investing is largely being driven by four main factors: (i) investor demand; (ii) regulatory fluidity and focus; (iii) expanding views of corporate purpose and fiduciary duty; and (iv) with respect to public companies, sustained ESG shareholder resolutions. However, this increasing interest in ESG among investors and asset managers alike has similarly intensified the focus on ESG and impact-focused funds by regulators.

SEC's Recent Focus on ESG Activities

In the past year, the SEC has taken several actions indicating its focus on adviser practices relating to ESG. In its list of 2020 exam priorities, the SEC's Office of Compliance Inspections and Examinations — the office charged with examining SEC-registered private equity fund advisers — noted its particular interest in the accuracy and adequacy of disclosures on sustainable and responsible investment strategies that incorporate ESG criteria.[5] In March, the SEC sought public input on mutual fund names that include terms such as "ESG" or "sustainable".[6] Most recently, on July 7, 2020, SEC Commissioner Elad L. Roisman spoke to the Society for Corporate Governance National Conference, with a focus on ESG disclosure by asset managers and public companies. ESG as the primary topic of the Commissioner's keynote is yet another indication that ESG is top of mind for both asset managers and regulators and further highlights the complexities and importance of certain disclosures related to ESG.

Key Takeaways for Private Equity

- **Importance of Accurate ESG Disclosures.** In light of the SEC's focus on ESG, private equity fund sponsors should be particularly mindful of any disclosures related to ESG, responsible investing or impact investing.
  - Any such disclosures should be reviewed carefully in consideration of the anti-fraud provisions of Section 206 of the Investment Advisers Act of 1940 (the "Advisers Act").
    - For example, sponsors should ensure that a fund's portfolio composition accurately reflects the types of investments contemplated by its stated investment strategy. Sponsors should also provide specificity as to how the fund

defines “ESG” or related terms and transparency and clarity on the prioritization of ESG goals in a fund’s returns.

- Disclosures on ESG or a fund’s investment strategy in any fund documents or marketing materials should accurately reflect the sponsor’s actual operational practices, and, as a best practice, sponsors should memorialize continued compliance with such disclosures.
- Sponsors also may want to assess the need for and compliance with an ESG policy to satisfy anticipated investor due diligence requests.
- Items of particular focus of SEC inquiries may include: internal definitions of ESG-related terms and descriptions of ESG factors, copies of ESG compliance policies and procedures, information on ESG investments made or recommended, methodologies used to score ESG investments, proxy votes made by the adviser pertaining to ESG matters, information on service providers used in connection with ESG investments, internal analysis that quantifies investment returns for ESG investments, performance information for certain ESG investments, and whether the adviser adheres to the PRI, among other items.

Increased Regulatory Scrutiny of ESG Investing for ERISA Plans.

Recent regulatory interest in ESG expands beyond the SEC.

On June 23, 2020, the DOL issued a proposed regulation (the “Proposed DOL Rule”) that, if enacted, would set additional guiderails for ERISA plan fiduciaries considering ESG factors in investment decisions. Although the DOL has shifted its guidance over the last 40 years regarding the extent to which ESG factors can be considered by ERISA fiduciaries, the Proposed DOL Rule continues to make clear that non-pecuniary considerations may not override economic considerations and would also limit the extent to which ESG investments can be included in 401(k) plans. The proposal further adds explicit fiduciary process and documentation requirements for all ERISA plan ESG investments.

Key Takeaways for Private Equity

- Pension plans represent a significant source of capital for private equity funds, with private sector pension funds accounting for approximately 12% of private equity investors,[7] and 401(k) plans may become a more important future investor in private equity funds in light of other recent DOL guidance (discussed further in our *Alert*). The DOL's longstanding prohibition on accepting "additional risk" as a result of ESG investing, which is confirmed in the Proposed DOL Rule, presents complexity for ERISA-regulated investors considering ESG investing.

- Because the Proposed DOL Rule restricts the ability of ERISA fiduciaries to consider non-economic ESG factors when evaluating an investment, asset managers may want to carefully consider whether and how to address ESG-related matters in materials provided to ERISA fiduciaries. Where applicable, asset managers may consider revising their marketing and disclosure materials to emphasize the material impact of ESG factors on the risk and/or return of their particular investment strategies.
- Private equity funds that incorporate ESG factors into their investment decisions may face additional questions from ERISA-regulated U.S. pension plan investors. Although the Proposed DOL Rule would not preclude ERISA investors from investing in such funds, the rule's requirements for additional documentation may result in intensified diligence requests from ERISA fiduciaries. It will be particularly important for ERISA fiduciaries to document clearly (i) which economic factors were considered in selecting an ESG investment alternative and (ii) that those economic factors were the only factors considered when evaluating a fund or selecting from among multiple funds. Private equity funds attempting to attract both U.S. and foreign pension fund investors could feel a particular tension, as global regulatory trends have largely been running in favor of the incorporation of ESG factors into pension funds' investment decision making.[8]

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1. *2020 Preqin Global Private Equity & Venture Capital Report.*↩

2. *2020 Preqin Global Private Equity & Venture Capital Report.*↩

3. *Preqin* article March 15, 2020, "ESG Will Become More Integral in the Next 36 Months, Alternatives Investors Say."↩

4. 2020 IFC Report: Growing Impact: New Insights into the Practice of Impact Investing.↩

5. SEC — Office of Compliance Inspections and Examinations, 2020 Examination Priorities (Jan. 7, 2020), https://www.sec.gov/about/offices/ocie/national-examination-program-priorities-2020.pdf.↩

6. See Request for Comment on Fund Names, Investment Company Act Release No. IC–33809; File No. S7-04-20 (March 2, 2020) *available at* https://www.sec.gov/rules/other/2020/ic-33809.pdf.↩

7. *Preqin Pro* data as of July 9, 2020.↩

8. Additional examples of foreign pension-related ESG regulations and policies are discussed in UNPRI's "responsible investment regulation map" (found at: https://www.unpri.org/sustainable-markets/regulation-map).↩

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